INSURANCE LAW

Post-claims Underwriting vs. An Insurer's Right to Rescind a Health Policy

by Richard A. Huver, Column Editor

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Imagine a potential new client presents in your office with the following scenario: your client applied for private health insurance rather than seeking coverage through her new employer because she wanted to keep her regular physicians (who were not covered by the employer's insurance). She completed an application based on her understanding it only sought information about her health and medical history, but not that of her husband or son. She answered the questions about herself truthfully and completely. Both she and her husband (who is to be a "covered family member") signed the application and also signed authorizations allowing the insurer to obtain their medical records. During the underwriting process, the insurance company did very little "underwriting" other than to clarify a few minor points with the wife. The insurer otherwise did not conduct any underwriting investigation and did not realize the application had omitted medical information regarding the husband.

Just two months after the policy was issued, the husband was hospitalized for severe stomach problems. The insurer started an investigation into the possibility of fraud and learned (for the first time) of the husband's long history of health issues, including obesity, hypertension and gastroesophageal reflux disease, none of which were disclosed on the application completed by the wife. The next month, the husband was in an auto accident which left him completely disabled. Ultimately, the health insurer paid over $475,000 in medical expenses on the husband's behalf. However, based on its fraud investigation, the insurer rescinded the policy, alleging willful misrepresentations and omissions in the application by husband. On top of that, the insurer now demands reimbursement for some of the expenses it did pay. Would you take that case?

Someone did -- and the resulting litigation led to a reported decision discussing an insurance company's duty to conduct a reasonable underwriting investigation before issuing a policy balanced against its right to rescind a policy based on willful misrepresentation.

In *Hailey v. California Physicians' Service* (2007) 158 Cal.App.4th 452 (as modified on Denial of Rehearing January 22, 2008, Review Denied March 26, 2008), just such a factual scenario was presented. Blue Shield rescinded the policy retroactive to the date of issuance and, without coverage, plaintiffs could no longer afford nursing care or physical therapy for Steve (the husband). Obtaining medical care elsewhere became impossible, allegedly leading to Steve's loss of the use of his bladder and permanent impairment of his ability to walk. *Id.* at 461-462.

Plaintiffs sued for breach of contract, bad faith and intentional infliction of emotional distress, contending Blue Shield had engaged in "post-claims underwriting." Plaintiffs relied on a statute enacted in 1993, Health and Safety Code §1389.3, which precludes a health services plan from rescinding a contract for a material misrepresentation or concealment **unless** it can demonstrate **either** that the misrepresentation/concealment was willful **or** the plan made reasonable efforts to ensure the application was accurate and complete before issuing the policy. *Id*. at 459.

Blue Cross filed a cross-complaint for declaratory relief seeking a finding it had legally rescinded the contract and, further, that it was entitled to recover the medical costs paid on Steve's behalf before the contract was rescinded. The trial court granted Blue Cross' demurrer to plaintiffs' intentional infliction of emotional distress claim. Moreover, the trial court granted Blue Cross' summary judgment motion on its declaratory relief cause of action and awarded Blue Cross more than $100,000 in medical expenses. *Id.* at 462.

There were several issues raised on appeal but only one will be addressed in this article. The pertinent issue was whether an insurer could rescind a policy based on a material misrepresentation even if its rescission was based on post-claims underwriting. The answer to the question turned on an analysis of Health & Safety Code §1389.3, which provides:

> **No health care service plan shall engage in the practice of postclaims underwriting. For purposes of this section, 'postclaims underwriting' means rescinding, canceling, or limiting of a plan contract due to the plan's failure to complete medical underwriting and resolve all reasonable questions arising from written information submitted on or with an application before issuing the plan contract. This section shall not limit a plan's remedies upon a showing of willful misrepresentation.**

As you might imagine, the parties disagreed regarding the interpretation of the last sentence in the statute. Did the Legislature carve out an exception to the prohibition against postclaims underwriting such that it was permissible for Blue Shield to rescind the policy through postclaims underwriting **if** the rescission was based on willful misrepresentation by the applicant?

Because the appeal arose from the trial court's grant of Blue Shield's motion for summary judgment, the appellate court's role was first to determine whether there were triable issues of fact which precluded the entry of judgment. In reviewing the evidence, the court concluded plaintiff wife's (Cindy) explanation for the omission of information regarding her husband was "not patently unbelievable." She explained the form was confusing and because she was the only "applicant," Blue Shield only wanted her medical information. The court agreed the form used by Blue Shield was "no model of clarity," hence lending credence to the confusion as to what information Cindy was required to provide. The court therefore concluded plaintiffs had, in fact, demonstrated a triable issue of fact existed as to whether they willfully misrepresented Steve's medical history. *Id.* at 798-799.

The court turned to the issue of whether Health & Safety Code §1389.3 precluded Blue Shield from engaging in post-claims underwriting as the basis for rescinding the policy. The analysis ultimately required citations to out-of-state cases and law review articles, apparently because there were no

California decisions discussing the statute. The court cited to Cady & Gates, *Post Claims Underwriting* (2000) 102 W.Va.L.Rev. 809, 813:

> **... post-claims underwriting occurs when an insurer 'wait[s] until a claim has been filed to obtain information and make underwriting decisions which should have been made when the application [for insurance] was made, not after the policy was issued.' ... In other words, the insurer did not assess an insured's eligibility for insurance, according to the risk he presents, until after insurance has been purchased and a claim has been made.**

Hailey v. California Physicians', supra, 158 Cal.App.4th at 465.

There were several reasons cited by the court as to why post-claims underwriting is problematic. First, it is patently unfair to a policyholder who buys insurance, pays the premiums and assumes there is coverage only to discover after filing a claim he is not insured. The policyholder cannot obtain a different policy to cover a loss which has already occurred. Hence, if he is not insurable, he should be advised before the policy is issued so he has a chance to obtain coverage elsewhere. *Id.*

Second, an insurance company faced with a substantial claim will have plenty of reasons to fly-speck an application looking for any excuse to rescind the policy.

> **...given sufficient impetus - such as chronic illness - it is likely that any health insurer will be able to find some detail within an insured's medical history that, post hoc, amounts to misrepresentation.**

Cady & Gates, *supra*, at p. 858.

Hence, it was important for an insurer to conduct an adequate inquiry on the front end of the application process to protect against this type of harm. "Given the likelihood of inadvertent error, accurate risk assessment requires a reasonable check on the information the insurer uses to evaluate the risk." *Hailey v. California Physicians', supra*, 158 Cal.App.4th at 466-467.

The *Hailey* court also considered the legislative intent behind the enactment of Health & Safety Code §1389.3, concluding:

> **The unmistakable purpose of section 1389.3's prohibition on "postclaims underwriting" is to prevent the unexpected cancellation of health care coverage at a time coverage is needed most.**

Id. at 467.

In reviewing the facts in *Hailey*, the court concluded Blue Shield had conducted an extensive investigation into Steve's medical history **only** after his claim was submitted. Conversely, Blue Shield had done little if any investigation at application time. Had Blue Shield simply asked Cindy if she had included information on her husband or son during a review of her application, the entire fiasco could have been avoided. In fact, both Cindy and her husband had signed authorizations for Blue Shield to obtain medical records from their doctors. "Blue Shield apparently had no difficulty

using this release to obtain Steve's medical records after he filed his initial claim." *Id.*

Another important point which led the court to its conclusion was an explanation of the purpose behind rescission law; *i.e.*, to restore both parties to their former position. Here, only Blue Shield was returned to its former position. Plaintiffs, on the other hand, were left without any coverage, unpaid medical bills and Steve developed a new preexisting condition which might prevent him from obtaining health coverage elsewhere. Thus, it was "impossible" to return plaintiffs to the *status quo ante* by use of rescission. *Id.* at 468-469.

Finally, the court cited to public policy grounds as further support for requiring insurance companies to conduct adequate precontract underwriting:

> **The sudden loss of health insurance after the onset of an acute illness or serious injury presents not only a financial disaster to the former subscriber, but places an additional strain on health providers and government resources already overburdened by the vast numbers of those without health insurance.**

Id. at 471.

The *Hailey* court ultimately did not answer the question posed at the beginning of this article -- whether an insurer can use post-claims underwriting to rescind a policy **if** the rescission is based on willful misrepresentation. Ultimately, based on the triable issues of fact the court concluded existed, there was no finding of willful misrepresentation. Application of the court's ultimate holding is thus limited to similar circumstances:

> **Here, <u>where no willful misrepresentation is established</u>, the statute explicitly precludes the insurer from "rescinding, canceling, or limiting ... a plan contract" (§1389.3) based on postclaims underwriting. ... Section 1389.3 expressly requires the insurer to complete its underwriting process "before issuing the plan contract."**
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> **An applicant for a health services plan has a responsibility to exercise care in completing an application. In light of the potentially catastrophic consequences of an applicant's error in filling out an application, however, we believe the Legislature has placed a concurrent duty on the plan to make reasonable efforts to ensure it has all the necessary information to accurately assess the risk before issuing the contract, if the plan wishes to preserve the right to later rescind <u>where it cannot show willful misrepresentation</u>.**

Id. (Emphasis added.)